

BEFORE THE STATE TAX APPEAL BOARD
OF THE STATE OF MONTANA

SEAN M. PATTEN,)	
)	DOCKET NO.: IT-2000-3
Appellant,)	
)	
-vs-)	FACTUAL BACKGROUND,
)	CONCLUSIONS OF LAW,
THE DEPARTMENT OF REVENUE)	ORDER and OPPORTUNITY
OF THE STATE OF MONTANA,)	<u>FOR JUDICIAL REVIEW</u>
)	
Respondent.)	

The above-entitled appeal was heard on October 12, 2001, in the City of Bozeman, Montana, in accordance with an order of the State Tax Appeal Board of the State of Montana (the Board). The notice of the hearing was duly given as required by law.

The Taxpayer, Sean M. Patten, presented testimony in support of the appeal. The Department of Revenue (DOR), represented by Ms. Sylvia Headley, Field Auditor, Region 4, Missoula, presented testimony in opposition to the appeal. In addition to testimony, exhibits were received in evidence. Mr. Patten is the appellant in this proceeding and, therefore, has the burden of proof. Based on the evidence, this Board finds as follows:

STATEMENT OF THE ISSUE

The issue in this matter is whether the Taxpayer should be allowed to deduct losses claimed on his 1996 and 1997 Montana individual tax return, resulting from a sub-chapter S corporation of which he is a member and a rental loss on his 1996 return.

FACTUAL BACKGROUND

1. Due, proper and sufficient notice was given of this matter, the hearing hereon, and of the time and place of the hearing. All parties were afforded the opportunity to present evidence, oral and documentary.

2. The Taxpayer timely filed his 1996 and 1997 Montana individual income tax returns. On these returns he claimed his share of a sub-chapter S corporation's losses: \$4,170.00 and \$12,116.00 respectively. Additionally, on his 1996 return, he claimed a loss of \$15,587.00 resulting from rental activities concerning the lower level of certain property located in Bozeman, Montana.

3. The Board has jurisdiction over this matter in accordance with Section 15-2-302, MCA.

4. A hearing was held on this matter on February 17, 2000 in Helena, Montana before David G. Olsen, DOR hearing examiner.

5. On July 12, 2000 the hearing examiner issued his decision on the matter finding that the DOR properly disallowed the Taxpayer's claimed sub-chapter S corporation losses on his 1996 and 1997 tax returns and the rental activity loss on his 1996 tax return.

6. Additionally, the hearing examiner abated the penalties and interest imposed by the DOR under the provisions of Section 15-30-321(2) MCA by finding those imposed by Section 15-30-142(6) MCA to be appropriate. Since this finding was not appealed, the finding remains and has not been considered by the Board.

7. The Taxpayer filed a timely appeal to this Board on September 2, 2000.

8. A final adjustment notice was issued to the Taxpayer by the DOR on March 30, 2000. The 25% deficiency penalty shown thereon was withdrawn by the DOR at the hearing before the Board.

TAXPAYER'S CONTENTIONS

Mr. Patten contends he is entitled to the losses in question because he owned the Bozeman real property on South Wilson in 1996 and 1997 and that the sub-chapter S corporation, BPM Corporation, which is a South Dakota corporation, was never engaged in business in Montana and thus not required to file Montana tax returns for 1996 and

1997.

In support of his contention that he owned the real property in question, Mr. Patten stated that the Bozeman property was purchased by the Taxpayer's parents by warranty deed dated September 30, 1987 (Taxpayer's Exhibit #4) and transferred by quitclaim deed to him from his parents on September 14, 1988 (Taxpayer's Exhibit #5). These two deeds were apparently recorded although Mr. Patten did not recall recording the quitclaim deed. Additionally, Mr. Patten stated he was a full time college student and too young at the time of the purchase of this property by his parents to obtain a mortgage on the property. Mr. Patten testified that he lived on the top floor of the property and rented out the lower level. He testified and introduced copies of checks dated 1987-1989 into evidence stating these checks were for the house payments and for maintenance (Taxpayer's Exhibit #6).

Mr. Patten also argued that BPM Corporation did no business in Montana during the years at issue and, thus, was not required to file a Montana tax return. Mr. Patten stated that the only activity reported on the corporation's Federal tax return was the profit or loss resulting from a family farm operation located in South Dakota. BPM Corporation did not report rental losses from the Bozeman

property on its Federal tax return and it has never filed a Montana tax return.

DOR'S CONTENTIONS

DOR, on the other hand, contends that Mr. Patten, the Taxpayer, did not own the Bozeman property during the years in question and that, in fact, the sub-chapter S corporation, BPM Corporation, owned the property. Further, BPM Corporation was engaged in the rental business in Montana at this time and was therefore required to file appropriate tax returns in Montana reporting gains or losses from the rental activity.

In support of DOR's contentions, Ms. Sylvia Headley, Field Auditor Region 4, offered the following:

Throughout the time period in question, the Taxpayer lived in the upper level of the Bozeman property. The lower level was rented in three units. The Taxpayer is a shareholder in BPM Corporation which is a South Dakota sub-chapter S corporation not licensed to do business in Montana and has never filed a Montana tax return. The Taxpayer owned 15% and 18% of the corporation in 1996 and 1997, respectively. Losses as described above were reported on the Taxpayer's 1996 and 1997 returns. The Bozeman property was purchased by the Taxpayer's parents by warranty deed on September 30, 1987. By warranty deed dated January 19,

1990, Mr. And Mrs. Patten conveyed the property to BPM Corporation (DOR's Exhibit F). This deed was filed in Gallatin County. On January 8, 1998 a quitclaim deed was filed in Gallatin County conveying the property from BPM Corporation to the Taxpayer (DOR's Exhibit G). On July 8, 1998 Mr. Patten filed a quitclaim deed conveying the property back to BPM Corporation, which was also filed in Gallatin County (DOR's Exhibit H). Five rental agreements were introduced by the DOR (DOR's Exhibit I). Three of these rental agreements, dated January, March and June of 1996, identify BPM Corporation as the "owner" of the property and two leases dated June of 1997 identify Mrs. Leigh Patten as the "landlord" of the property. Mrs. Patten, the Taxpayer's mother, is the corporate secretary of BPM Corporation. All lease payments were to be paid to the Taxpayer. On January 3, 1993 an agreement for rental of the Bozeman property was reached between the Taxpayer and BPM Corporation and executed between "Leigh Patten, Secretary BPM Corp." and the Taxpayer (DOR's Exhibit J). Under the terms of this agreement the Taxpayer was to maintain the property, collect the rents, which were assigned to him, and pay taxes on the property in return for a yearly property lease payment of \$1,200.00 to BPM Corporation. DOR introduced a property tax notice and special assessment on

the property for the years 1997 and 1998 showing delinquent taxes owed on the property to the City of Bozeman and the county which named BPM Corporation as the owner of the property (DOR's Exhibit D).

DOR contends that while a taxpayer may make a gratuitous assignment of his income to another, the Taxpayer nevertheless remains liable for the tax on it just as if he had actually received the income himself. The classic statement of the assignment of income doctrine was made by Justice Holmes when the Supreme Court stated in Lucas v. Earl, Guy, 281 U.S. 111 (1930), 74 L. Ed. 731, that it would not recognize for income tax purposes an "arrangement by which the fruits are attributed to a different tree from that on which they grew." See also Com. V. Bateman, Lady Marian, 127 F. 2d. 266 (Cal. 1942). In Bing, Leo v. Borvera, 26 F. 2d 1017 (Cal. 2d 1928), affg. 22 F 2d 450; Seaman, Wareham, 55 T.C. 292, the Court held an assignment of rents will not shift the income for tax purposes to the assignee. The rental income is taxable to the assignor-lessor just as it would have been had he made a gift of the income immediately after receiving it. "The owner of property cannot escape taxation on rent derived from the property by a gift or assignment of the rent to another." Seamen, Wareham, 55 T.C. 292. Thus, DOR contends that BPM

Corporation and not the Taxpayer, owned the Bozeman property in question during 1996 and 1997 and that the corporation cannot escape taxation on the rental income by assigning the rents to Mr. Patten, the Taxpayer. Further, BPM Corporation was engaged in the rental business in Montana in 1996 and 1997 and therefore must file Montana tax returns. Income from rent is included in gross income. 26 U.S.C. §61 (a)(5). A small business corporation engaged in business in Montana is required to file a corporate license tax return. Sections 15-31-111 and 15-31-201 MCA. A loss is not allowed on a Montana individual income tax return of a small business corporation shareholder unless the corporation files a corporate tax return as required by Section 15-30-202, MCA. ARM 42.15.306(1)(b). Section 15-30-202 was repealed beginning October 1, 2001. See Section 15-30-1101 MCA.

BOARD'S DISCUSSION

As stated above, the issue in this matter is whether the Taxpayer should be allowed to deduct a rental activity loss on his 1996 individual income tax return and subchapter S corporation losses on both his 1996 and 1997 returns. The key to deciding the rental activity loss is who owned the Bozeman property at the time in question. Following the September 1987 acquisition of the Bozeman property by the

Taxpayer's parents by warranty deed, a number of related party transfers occurred. On September 14, 1988 the Taxpayer's parents transferred the property to him by quitclaim deed. Then, on January 19, 1990 the Taxpayer's parents transferred the property to BPM Corporation by warranty deed. On January 8, 1998 BPM Corporation transferred the property to the Taxpayer by quitclaim deed which was signed by the Taxpayer as President of BPM Corporation. Finally, on July 9, 1998 the Taxpayer transferred the property back to BPM Corporation by quitclaim deed. The Taxpayer admitted at the hearing that he never took any action to enforce the quitclaim title to him by his parents on September 14, 1988. Three rental agreements were entered into between BPM Corporation as "owner" and three renters in 1996 and two leases in 1997 where the leases were executed on behalf of BPM Corporation by its corporate secretary as "Landlord." Additionally, the property tax notice in 1998 identified BPM Corporation as the owner of the property in 1997. Therefore, the clear and convincing evidence and indeed overwhelming evidence demonstrates that BPM Corporation owned the property in question during the time periods at issue. Since the owner-lessor for the above leases was BPM Corporation, it was properly considered to be in the rental business in Montana

and therefore required to file appropriate Montana tax returns for the years in question. It did not and, in fact, has never filed a tax return in Montana. Thus, the subchapter S losses were properly disallowed.

CONCLUSIONS OF LAW

1. Section 15-2-302, MCA. Direct appeal from department decision to state tax appeal board - hearing. (2)(a) Except as provided in subsection (2)(b), the appeal is made by filing a complaint with the board within 30 days following receipt of notice of the department's final decision.
2. Income from rent is included in gross income. 26 U.S.C. § 61 (a)(5).
3. A small business corporation engaged in business in Montana is required to file a corporate license tax return. Sections 15-31-111 and 15-31-201 MCA.
4. A loss is not allowed on a Montana individual income tax return of a small business corporation shareholder unless the corporation files a corporate tax return as required by Section 15-30-202 MCA.
5. The appeal of the Taxpayer is hereby denied and the decision of the Department of Revenue upheld.

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ORDER

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the final adjustments to the Taxpayer's 1996 and 1997 tax returns shall be approved as made.

DATED this 29th day of October, 2001.

BY ORDER OF THE
STATE TAX APPEAL BOARD

(S E A L)

GREGORY A. THORNQUIST, Chairman

JEREANN NELSON, Member

MICHAEL J. MULRONEY, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 29th day of October, 2001, the foregoing Order of the Board was served on the parties hereto by depositing a copy thereof in the U.S. Mails, postage prepaid, addressed to the parties as follows:

Sean M. Patten
2107 Highland Court
Bozeman, MT 59715

Office of Legal Affairs
Department of Revenue
Mitchell Building
Helena, MT 59620

Sylvia Headley
Auditor
Compliance, Valuation, and Resolution Process
Montana Department of Revenue
1610 South 3rd Street West #105
Missoula, MT 59801

DONNA EUBANK
Paralegal